

THE RICHBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

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A House of Cards

"The effects of an earthquake are, in part, a function of the strength of the original shocks, in part, a function of the strength of the buildings affected."

— *The Great Depression*, Lionel Robbins,
Macmillan and Co., Ltd., London, 1934

We cite the above quote as we consider the sustainability of the current U.S. economic expansion and Wall Street's bull market. This month, we again examine the foundations on which these expansions are based, and find more evidence that they are not as sound as they appear, but that they have been eroding at their core.

We will show how the economic expansion in the U.S. has been supported principally by a credit-fueled consumption boom, and how the withering consumer debt cycle will lead to an end of the spending spree. We will demonstrate how the inevitable decline of speculative lending is already taking place and heavily impacting finance companies — a sector that, along with high tech (which also faces declining sales and profits), has comprised the bulk of U.S. economic growth and profit gains in the U.S. market over the past 2 years.

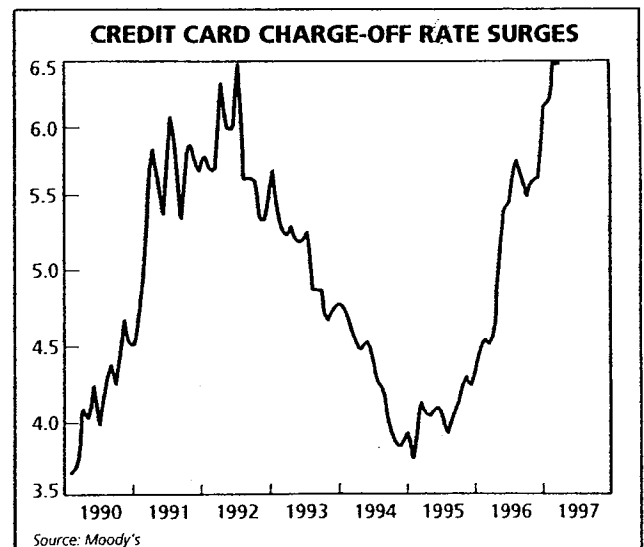
We return to the problem of the stagnation of real investment in sectors other than the computer industry and we show that for the last year the bull market has been in big-cap, index-linked stocks, while the broader market has been progressively weakening. Finally, we discuss how the fading cyclical strength of the U.S. economy will be exacerbated by the widening current account deficit, which in turn will weigh on the dollar.

GIVING CREDIT WHERE NONE IS DUE

The Fed has, after all, hiked its federal funds rate. But did this increase of a quarter of a percentage point truly tighten credit? No. A central theme of our analysis continues to be that the United States has been experiencing an unprecedented — and ultimately unsustainable — consumption binge that has been fueled by aggressive and unrestrained consumer lending and borrowing.

For evidence of how extremely loose credit in America really is, all one has to do is watch cable television where former star athletes with toll free numbers pitch home equity and used-auto loans to consumers with problem credit. Bordering on the unbelievable, lending companies now advertise toll free phone numbers to provide credit for hair transplants, plastic surgery, and home equity loans to poor credit risks up to 125 percent of equity. When selling furniture, computers, exercise equipment, etc., retailers now routinely offer credit with no money down and no payments for up to twelve months. Lending and borrowing are reckless as never before.

With the sole quest of satisfying investors' yearning



for rapid earnings growth and associated increases in stock prices, most lenders have progressively lowered their credit standards and expanded into more and more obscure products to lend against. With stock investors, eagerly snapping up the IPOs of lenders, and with insatiable demand from buyers of securitized loans, the lending floodgates were opened widely.

Observing in the course of last year a sharp downturn in consumer installment and credit card debt growth and a concurrent pronounced weakening of construction and business investment, we jumped to the conclusion that the U.S. business cycle was petering out.

Just the opposite did occur; the economy gained new momentum, mainly through soaring consumer spending, up at an annual rate of more than 5 percent, the strongest quarterly rise in many years (and consumption makes up two-thirds of GDP). More than that, real disposable household incomes seem to have surged at an annual rate of about 8 percent. Retail sales increased from the fourth quarter at an annual record rate of 13.1 percent, the largest gain in 10 years:

In the absence of sharply higher borrowing, it must be assumed that this new spending spree came from the relatively affluent, cash-rich part of the people who can raise their spending relative to income without resorting to installment and credit card debt. Instead of borrowing, they run down their cash balances, save less, take out new mortgages, or borrow against their 401(K) plans.

Spending can be increased not only by obtaining credit but also by reducing money balances, which is not picked up in government data. As stated before, the U.S. GDP statistics are currently in an unusual mess.

Given the withering consumer debt cycle, there is one single plausible explanation left: the big capital gains in the stock market have been strongly spilling over into the economy. But why just now, why not earlier? It appears no less plausible that the wealth effects intensify the longer the rise in asset values has proceeded. As further capital gains are widely taken for granted, people shift from recognizing capital gains to anticipating them. Stock investors' "irrational exuberance" turns into wealth euphoria. After all, this turn of events fits perfectly the current euphoria, which is evidenced by recent surveys that show consumer confidence at a 27-year high and rising.

It really seems an irony that this extraordinary "wealth-driven" spending spree now precisely coincides with a sharp downturn in the U.S. stock market, most probably thus stalling this spending again. In reality, it's by no means an irony. Rather, it has its self-explanatory logic in the fact that a widespread attempt to take profits out of the market by selling stocks must essentially depress their prices.

U.S. CONSUMPTION BOOM: RED FLAG OR RED HERRING?

Wall Street lore has it that this consumption frenzy has every prospect of enjoying a long life because it is powered by strong employment and income growth. Very true, strong income streams feed on themselves, but to keep such a stream expanding, it needs something that adds to it. What is it? That is the crucial, vexing question.

Domestically, additions to the income and spending stream must essentially come from two main sources; credit creation or a reduction of money balances. These two, and these two alone make for the growth of incomes. To explain strong income growth with strong income growth is economic bunk. The borrowing and spending may be done either by businesses, the government or the consumer. In the U.S. case, the main borrower who drives the strong growth in consumer incomes is the consumer himself.

On closer look, we see in the United States two different groups of overspending consumers: those with

low incomes, owning few or no assets, and who depend fully on the debt spigot; and the affluent, with higher incomes and more or less substantial participation in the stock market boom, who are able to finance their higher spending either by borrowing against their inflated assets or by realizing part of their capital gains. This consumption boom, for sure, is fueled by a combination of these sources.

We are left to evaluate the sustainability of this consumption boom. In contrast to Wall Street's complacent view, we regard it as extremely vulnerable to possible, sudden disruption. Again, it seems appropriate to distinguish in this assessment between the two groups of borrowers: the relatively poor and the affluent.

The surging delinquency rates and record personal bankruptcies that bewilder analysts but which Wall Street discards as being of marginal importance, obviously refer to the relatively poor part of the population. Actually, the crucial changes in the economy are always at the margin. What's more, recent reports from sub-prime lenders and the credit card industry suggest a looming financial disaster.

The first major shock came in late January as the largest sub-prime lender, Mercury Finance, announced that "improper accounting entries" would lead to losses and the restatement of prior years' earnings reports. Only days later, sub-prime lender Jayhawk Acceptance disclosed that heavy losses would force the company to seek bankruptcy protection. Subsequently, one small lender after the other reported heavy losses, often in connection with "accounting irregularities."

Similar severe distortions were reported in the credit card industry. Overall, card issuers wrote off 6.39 percent of their total loans in January, exceeding the June 1992 recession-related peak of 6.36 percent. According to another report, chargeoffs of card issuers reached in February a 54-month high of \$754 million, or 6.17 percent of total loans. The aggressive lending practices in 1995 and 1996 are finally taking their toll. Advanta, a major credit card lender, announced an increase in its provision for losses by 300 percent to over \$60 million, resulting in a \$20 million loss for the first quarter, after earning \$45 million in the fourth quarter of last year.

In hindsight, it emerges that the apparent healthy profit growth of these aggressive lenders had two dubious sources: a combination of extremely tepid loan growth and the liberal use of favorable accounting methods — in particular, systematic underaccrual for future loan charge-offs. For years, the illusion of sound lending was conjured up by the circumstance that delinquencies, while growing

SHARES OF FINANCE COMPANIES CRASH

	1997		%
MAJOR CONSUMER FINANCE COS.	HIGH	CURRENT	DECLINE
GREENTREE ACCEPTANCE	41.250	32.625	-21%
ADVANTA	57.500	24.000	-58%
CAPITAL ONE FINANCIAL	43.625	34.500	-21%
MBNA FINANCIAL	37.125	29.750	-20%
HOUSEHOLD INTERNATIONAL	105.625	83.000	-21%
	52 WEEK		%
SUB-PRIME FINANCE COS.	HIGH	CURRENT	DECLINE
CITYSCAPE	36.50	14.75	-59.6%
GENERAL ACCEPTANCE CORP.	9.75	3.88	-60.3%
OLYMPIC FINANCIAL	26.25	8.13	-69.0%
CREDIT ACCEPTANCE CORP.	28.38	17.50	-38.3%
WORLD ACCEPTANCE CORP.	11.13	5.13	-53.9%
FIRST MERCHANTS ACCEPTANCE	26.38	3.25	-67.7%
AMMES FINANCIAL	39.33	16.63	-57.7%
JAYHAWK ACCEPTANCE	15.25	2.00	-88.9%
MONEY STORE	31.63	21.00	-33.6%
NAL FINANCIAL	16.13	2.50	-84.5%
UNION ACCEPTANCE	22.25	10.25	-53.9%
UNITED COMPANIES FINANCIAL	39.00	19.38	-50.3%
RELIANCE ACCEPTANCE	32.00	9.38	-70.7%
CONSUMER PORTFOLIO SERVICES	14.83	7.75	-47.0%
MERCURY FINANCE	15.75	2.38	-84.9%
FIRST ENTERPRISE FINANCIAL	14.00	5.75	-58.9%
UGLY DUCKLING	24.88	14.50	-41.7%

dramatically in actual dollar terms, were declining as a percentage of the skyrocketing loan growth.

Though Advanta definitely planted the seeds of its present problems with loan growth rates of more than 30 percent in 1996 and 50 percent in 1995, it was this staggering expansion that had kept the delinquency ratio low. As soon as loan growth came to a near-halt in 1997's first quarter (credit card receivables grew barely 1/2 of 1 percent), charge-offs ballooned to 6.6 percent of receivables. That's more than their equity.

With about \$800 million of equity supporting over \$16 billion of managed receivables, Advanta's supposedly sound fundamentals vanished virtually overnight. Though a large part of the managed receivables has been securitized with no recourse, the investors in asset-backed securities rely on a strict implied guarantee from its issuers. Severe ramifications would reverberate through the entire asset-backed market and industry if an industry leader such as Advanta would repudiate its obligation.

Clearly, there is serious trouble looming in consumer credit — more precisely, in installment and credit card borrowing. As the chart at the top right of this page shows, its growth rate has plunged from a cyclical peak of 15.1 percent in the second quarter of 1995 to 5.5 percent in the fourth quarter of 1996, clearly heralding an imminent downturn in consumer demand.

Surprisingly, consumer demand instead accelerated because another dynamic began to work in the opposite direction, sharply boosting consumer demand: drastically lower savings by the more wealthy people. Here, the connection with the big capital gains provided by the particularly steep rise of U.S. stock prices in 1996's last months seems self-evident — in other words, a spill-over effect from the stock market bubble.

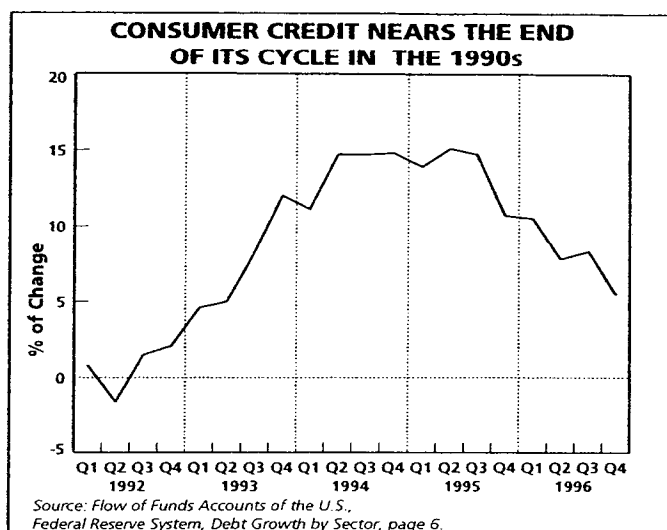
How dependable is such a spending boom against capital gains? Not at all, of course. Essentially, it is extremely vulnerable to a change in market sentiment and implies that a bear stock market carries a very high risk for a dramatic decline in consumer spending and thus for the economy in general. There is one historical precedent: the coincident collapse of the stock market and consumer spending in 1929-30.

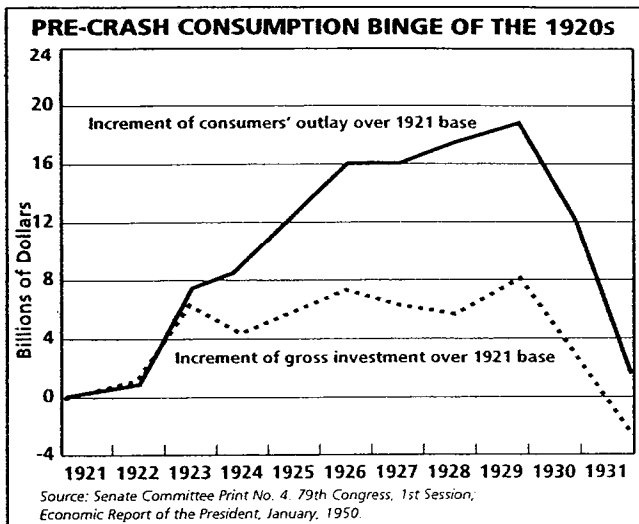
KEYNES 1928: IS THERE INFLATION IN THE UNITED STATES?

As a matter of fact, this title is not of our own choosing. It is from the Collected Writings of John Maynard Keynes (Volume XIII) and relates to an episode that happened in the autumn of 1928 which developed out of a discussion within the board of the National Mutual Assurance Company, of which Keynes was chairman.

The dispute and following exchange of letters under the heading "Is there inflation in the United States?", arose out of an acrimonious debate with another member of the National Mutual board, Mr. O.T. Falk. The dispute was about what the Federal Reserve authorities were likely to do in response to the excessive boom on the New York Stock Exchange. Falk expressed his belief that "the Fed would deal with the situation through a policy of tight money", which would reduce share prices. If the Fed did not act, he believed, there would be a retraction from current price levels which might be severe. In either case, Mr. Falk suggested that National Mutual "dispose of the bulk of its American securities."

Keynes disagreed and after the discussion wrote two extensive papers about this question, which he





circulated to economists, bankers and officials, as well as the National Mutual board. Of the two, only one is reprinted in full in his collective works.

Keynes vehemently refused to apply the concept of inflation to a booming stock market as long as it does not feed through overinvestment into the prices of goods and services. Verbatim: "Inflation means that for some reason or another, the stream of consumers' buying is increasing faster than the stream of finished goods available for them to buy, with the result that prices rise. It is not convenient to mean by it anything else. But we might give the name latent or potential inflation to a situation which is likely to lead to actual inflation if it is allowed to develop unchecked."

In the rest of the paper he explains that what counts are not the rising stock prices as such, but their stimulative effect on investment. Seeing no evidence of overinvestment, he saw no fault with the booming stock market. The paper drew reactions from several American and British economists. The Americans, in particular, objected sharply to Keynes' narrow view of inflation.

One answer came from a member of the Federal Reserve Bank of New York, W.R. Burgess, who professed to have discussed it with the sick Governor Strong. He pointed out that Strong had read the memorandum with the greatest interest but had "found in it so many points where he believes either your facts or your conclusions are wrong that, with his limited strength, it would be too much a task to attempt a reply." Mr. Burgess reports Governor Strong as saying, "I do not think we have had a serious inflation in this country but I do think we have been in grave danger or it and have some inflation in particular directions, all of which depends on the definition of inflation."

In a postscript, Burgess gives notice that he agreed with 98 percent of the letter that another Fed member, C. Snyder, had written to Keynes. Snyder, also verbatim: "There does not seem a great deal of mystery in what has happened in this country in the past year or more. Owing to the abundance of credit, in excess of even what appears to be the maximum possible growth of trade, there came a heavy expansion of bank investment amounting, for the whole country, to something like a billion and a half within a twelvemonth. This buying, of course gave a tremendous lift to the stock market, and there ensued a corresponding expansion of speculative loans."

Mr. C.J. Bullock, president of the Harvard Economic Society put it most succinctly: He focused on the "excessive credit expansion" arising from an explosive increase in bond and stock issues. He stressed, "I do not see the propriety in limiting the word 'inflation' to commodity price inflation. Of course, its use in economics was originally purely figurative, and I don't know that we have any standard definitions to go by, but nothing in the etymology or history of the word 'inflation' justifies us in limiting it to commodity prices. When I say this, I hasten to add that for the student of the business cycles, commodity price inflation has peculiar importance; but I am not ready to say that this is the only kind of inflation that is significant."

In his answers, Keynes insisted that a central bank should never try to stop speculation: "If too prolonged an attempt is made to check the speculative position by dear money, it may very well be that the dear money, by checking new investments, will bring about a business depression." He actually opined that credit for speculation may have a deflationary effect, if it takes something from the credit available for investment.

As to be inferred from his correspondence, the Wall Street crash in October 1929 did take Keynes

completely by surprise. While he had insisted in his correspondence that there was no inflation, he had actually been betting heavily on impending commodity inflation with sizable bullish positions mainly in rubber, corn, cotton and tin, which had started to slump in 1928. His losses on commodities forced him to sell securities to cover his losses. By the end of 1929, Keynes' net worth had slumped from £44,000 (in today's prices about one million pounds) to £7,815. In other words, he lost 82 percent of his wealth.

Mr. Falk, who had in 1928 warned of a downturn on Wall Street, reversed his opinion in the summer of 1929 to highly bullish, now against the advice of Keynes. He involved the company and himself in heavy losses that forced him to sell his house. One co-director of the insurance company committed suicide in the face of total personal financial ruin.

THE OMINOUS PARALLEL: 1929-1997

We have recalled this particular episode because it touches upon some important parallels between then and today. To be sure, it is common to all asset bubbles that they always occur against the backdrop of low consumer price inflation. In the 1920s, it had been zero during most of the decade. In fact, low goods price inflation that keeps monetary tightening at bay is the very prerequisite to the emergence of an asset price bubble. So it was in the case of Japan's bubble in the late 1980s.

Keynes, by the way, was right in insisting in his correspondence that there was no overinvestment in the late 1920s. What he overlooked, focusing exclusively on consumer prices, was the blatant excess in consumer spending.

US economic growth had since 1925-26 become grossly imbalanced. While the investment cycle had peaked, consumption alone boomed, apparently in the wake of the booming stock market (see chart at top left of page 5). At the same time, declining construction did offset a modest rise in business investment.

Given the severity of the Depression in the United States, it is remarkable how little is known about its sectoral pattern. In general, attention has dwelled on the stock market and the basic question, whether and when monetary policy was too loose or too tight.

We have always subscribed to the key postulate of the Austrian school that the severity of any recession or depression is largely the function of the magnitude of the excesses and maladjustments which developed during the preceding boom as the outgrowth of monetary looseness. Its primary and most spectacular effect in 1928-29 was the stock market bubble. Only token appreciation has been accorded to the derivative bubble effect in the real economy, with buoyant consumer spending accounting for 93 percent of U.S. GDP growth between 1925 and 1929.

Of the renowned economists who wrote about the Depression and its causes, only one, Joseph A. Schumpeter, mentions the prior heavy consumer borrowing. Schumpeter refers to various studies on the subject, including a survey of 23,779 retail stores, which in 1927 showed that only 58.8 percent of their sales were on cash. Motor car dealers sold, according to an estimate, 58 percent on installment; furniture dealers sold 57.7 percent on installment. In his book "The World in Depression 1929-1939", Kindleberger states, "in the United States, the boom was built around the automobile.... Electrical appliances such as radios, refrigerators, and vacuum cleaners, which had been unknown at the start of the decade, were commonplace by 1929." In short, the driving force of the business cycle in the 1920s was consumer durables, involving both heavy consumer borrowing and business investment.

But growth in outlays on plant and equipment and construction peaked already in 1925-26. At the time,

all signs pointed to a weakening economy, which would have marked the end of the postwar expansion. But responding also to British pleas for easier money in the United States to support the British pound, the Federal Reserve complied in August 1927 with a discount rate cut to 3.5 percent, accompanied by open market purchases on an appreciable scale.

FROM JOINT BOOM TO JOINT CRASH

Working mainly through an explosive rise in security issues, the resulting credit inflation found its way overwhelmingly into the stock market and consumer spending. Very little of it went into commercial loans or investment activity, which flagged. All this occurred against the background of zero consumer price inflation. While prolonging the economic expansion for another two years, the rampant credit expansion generated in the same vein the two major, fatal excesses and maladjustments in the economy and the financial system that were to precipitate the Depression: booming stock prices and booming consumption.

Given the overexpansion of consumption in the late 1920s, its instant steep plunge in 1930 was only natural. As soon as the stock market crashed in October 1929, the boom-related artificial and essentially temporary prop to consumer spending evaporated. Many people saw the savings of a lifetime rudely vanish almost overnight, necessitating a sharp downward revision of their standard of living. As equity prices and consumer spending had in tandem boomed, they were also to collapse in tandem.

Actually, of all features of the Depression, the precipitous decline of consumer spending is the one that was utterly at variance with the pattern of past recessions. Consumption plunged in 1930 by 5.4 percent and in the four years to 1933 overall by 18 percent. It is true that investment expenditures fell, percentage-wise, more steeply, but this is normal and was even a bit less than in past recessions. The other unique depressive influence in the 1930s was a virtual collapse of agriculture.

WHAT WILL HAPPEN WHEN THE MUSIC STOPS?

We have briefly recapitulated the events shortly before and after the stock market crash in October 1929 in order to point to the most striking parallel with the present. That is the conjunction of a prolonged boom in the stock market (asset bubble) and an economic expansion that is increasingly powered by consumer spending against capital gains.

The important lesson of 1929-33 for the present, in our view, is that such an economic expansion is vulnerable in the extreme. Once the music, that is the bull run of the stock market, definitely stops or even turns into a bear market, which is sure to happen one day, the U.S. economy is prone to a drastic, protracted decline in sales, incomes and profits.

For numerous Americans, just as in the late 1920s, the stock market — not liquid passbook accounts or money market funds — is where the savings for retirement or educating their children have been stashed. Today, some 84 million adults own stocks, double the rate of the late 1980s. Three-quarters of the money in mutual funds has been invested since 1990, and a large part at the high levels of the last two years. At the same time, the ratio of consumer debt to income is at its highest level since the 1930s and the aggregate debt service payment burden is also near a secular high.

It is easy to pour scorn over those who have so far sounded false alarm about the great dangers inherent in this dual bubble of booming equities and booming consumption. Yet, it's stupid because the final crash is only a question of time. Nobody knows how much consumer debt is too much. But the critical factor is not simply its level but the rate of change, both in stock prices and debt growth. Just as the drug addict needs ever

greater injections to prevent or merely postpone the painful withdrawal symptoms, so a bubble economy needs ever higher asset values and ever larger borrowings to postpone the final crash. But that is not possible ad infinitum. To paraphrase the words of Jean Baptiste Say about government debt: it is impossible to avoid a precipice if one follows a road that leads nowhere else.

WHAT WILL PRICK THE BUBBLE?

The U.S. economy looks strong and has a lot of forward momentum. But for the reasons explained, it is highly vulnerable to a setback in the grossly overvalued stock market. Other big potential negatives are lurking in the trade balance, the computer investment boom, and business profits.

U.S. GDP growth in 1997's first quarter will surprise on the downside because a soaring trade deficit will cut it down by about 2.5 percentage points or more. However, that is largely a correction of the opposite statistical distortion in 1996's last quarter. The main prop for the economy is the consumption boom, the sustainability of which we regard with great doubt.

Second in our list of factors leading to an overall economic weakening is the high tech sector. As pointed out in the last letter, booming computer investment has in the last two years masked near-stagnation in other investment categories. A recent cover story in *Business Week* about the dominant role of high tech investment in the present U.S. economic expansion did beat our worst suppositions. In the past three years, it accounted for 27 percent of real U.S. GDP growth, and last year for 33 percent, as against 4 percent for autos and 14 percent for residential building. That seems rather lopsided. High tech, in other words, has gained a size that makes or breaks the growth of the whole economy. After annual growth rates of 40 percent and more in high tech in the last three years, this demand and output component is surely prone to substantial weakening.

Third in our trouble spot list are business profits. The long bull market in equities clearly had powerful support from outstanding profit performance in the 1990s. But as we have repeatedly pointed out, this profit boom did not at all originate in an improving productivity trend, as Wall Street wants to make believe, but mainly in the extraordinary one-off plunge in interest costs. Given continuous very low productivity gains, sharply lower future profit growth is virtually certain, and for that we have been looking. In the official GDP and income accounts, profits are, in fact, stagnating since the end of 1995. In this light, the reported business profits, on which Wall Street preferably focuses, appear too good to be true.

Weighing these and other factors, we regard the U.S. economy's present strength not as a new trend but as a temporary aberration. In accordance, we don't see a possible sequence of further rate hikes. Rather the Fed is going to stay as loose as ever. The economy will lose steam on its own. The extent and speed of its decline will heavily depend on the further performance of the stock market, which equally is much weaker than it looks when measured by the popular stock indexes.

BEAR MARKET BEGINNINGS

As we listen to money managers, analysts and pundits, we are reminded of the old Wall Street adage, "You know you are in a bear market when stock prices go down but investors feel good about it". In the face of painful price collapses, the mood in the market remains remarkably upbeat. After all, the most popular stock price indexes, Dow Jones and Standard & Poor's 500, are still up since the beginning of the year, after extremely steep rises in 1996 and 1995.

In fact, the consensus view is that the market is just undergoing a healthy short-lived correction, with the secular bull market still intact. For many, the economic backdrop of moderate economic growth, solid

corporate profits and low inflation appears simply too positive for the possibility of a plunging stock market. This perception could well prove the “hook” that keeps the public in a bullish mood, even though the market at large is drifting.

There is a virtual refusal to see that the action in the stock market over the past months differs fundamentally from what happened in the last six years. The 1995-1996 period, in particular, was distinguished by a comforting lack of volatility, a preponderance of strength in individual issues as well as sectors, and only brief periods of weakness that quickly led to even stronger bull advances. This year's pattern is nearly its opposite image, with wild volatility, weakness prevailing for the vast majority of stocks and groups, and, most telling, only brief rallies succumbing to more painful sell-offs. Weakness, particularly in the NASDAQ market, has left many of past years' favorite mutual funds in disrepute after suffering considerable losses.

DECEPTIVE INDEXES

In hindsight, the change in the market trend began almost twelve months ago. After last spring's “buyer's panic” in the small caps, characterized by reckless speculative buying and a severe short squeeze, the Russell 2,000 index has made no progress. More and more stocks have been losing ground over the last twelve months, long before the Fed's recent rate hike sent the entire market into a swoon.

After the small cap debacle, speculative interest moved to the large caps, especially the larger NASDAQ technology stocks. Here, too, similar earlier spectacular gains in last year's fourth quarter ended in January this year in a painful “blow-off”. Since then, the NDX/NASDAQ 100 index has declined more than 15 percent as many technology stocks have been crushed (see table on page 11 of last month's letter). If not for the strong performance of Microsoft and a small group of PC and semiconductor companies, the losses to the technology and NASDAQ indices would be far greater.

Meanwhile, the vast majority of smaller stocks has suffered declines and the ranks of the losers are rapidly growing. Of the 7,900-odd stocks that traded on March 31, 1996 and were still around a year later, nearly 3,600 — or 45 percent — had fallen by mid-March of this year. And, according to S&P, about 50 percent of all stocks declined between Dec. 31, 1996 and March 31, 1997.

We have for some time been aware of this dramatic divergence in the performance of U.S. stocks but were unable to quantify it. That was fortunately done for us in great detail by two articles that we recommend to read for further information: “The Myths of Oz”, Newsweek, April 7, 1997; and “Where the Bear Lurks”, Business Week, April 7, 1997.

What's more, and a noteworthy departure from the past, the stocks that have crashed just do not rally. In a market that has been so dominated by momentum players, there is a dearth of anything resembling momentum. In addition, it emerges that the smaller stocks, of which the mutual funds are heavily loaded, simply have no liquidity, suggesting that there are many eager sellers out there waiting for any rally to trim positions.

All this said, the thing to see is that the movements of the Dow and the S&P 500 give an utterly false picture of the true situation in the overall market. On April 23, when the Dow leapt 173.38 points, or 2.6 percent, scoring its biggest gain in nine years, the Russell 2000 index edged lower. Continuing strength in the blue chips has been diverting attention from the disasters in the overall market. The indexing tail is wagging the market dog. Most probably, this index obsession is the other “hook” that keeps the public in a bullish mood and fully invested.

The important thing to realize for the investor is that only a small part of the market is truly liquid —

namely the big-cap stocks that dominate the indexes. Many fund groups are overloaded with illiquid stocks. As more investors buy index funds, the higher the stocks in the index go. But we still see another reason for this index mania: the ever-growing use of index-related derivatives trading to hedge against losses.

We think this is the real wild card in this environment. With most funds grossly underperforming the indices, the pressure to hedge against losses and to improve the performance through speculative trading in derivatives is immense. Thus, managers have resorted to aggressively buying and selling these instruments hoping to exploit fluctuations and to have insurance for a market break. The primary result of the frenzied trading of these highly leveraged instruments is today's wild volatility. If the indexes rally, suffering fund managers rush to reverse their hedges by buying the individual stocks comprising the index, often leading to unusually big gains in the Dow and the S&P 500.

What next? We see two influences at work in the U.S. stock market. The one is the overperformance of a limited number of big-cap index-linked stocks, camouflaging the broad market's progressive weakening: the other one is changes in short-term market sentiment.

Trying to weigh these two influences, we regard the deterioration in the broad market that started more than a year ago as the overriding circumstance for the long run. For most stocks and most investors, the bear market is already for some time painful reality, despite the investing community's upbeat mood. We are not sure what has caused it. Nor, however, do we see anything that might reverse it. We suspect the basic reason for this drastic narrowing of the stock market boom lies in the fact that with soaring prices the market needs ever more liquidity to keep going, and that is not forthcoming.

Wondering about the short run, the bullish spirits might well temporarily return, once the economy shows signs of a pronounced economic slowdown, quelling fears of further rate hikes. But no more than just another very narrow rally is, in our view, feasible. For later this year and early next year, we see distinctly more economic weakness than the stock market will like.

For the reasons explained, we regard this U.S. consumer spending spree and the associated strong job and income growth as hollow and fragile. They all depend heavily on two unsustainable trends: soaring debts and the intangible stock-market induced wealth euphoria. The actual sharply lower credit growth suggests that the debt binge has largely exhausted itself. It becomes truly alarming when one considers the probability of a prolonged bear stock market, shifting the wealth effect, too, into reverse.

We note that we are not alone in recognizing the parallel with 1929. The most recent issue of Industry Forecast, published by the Jerome Levy Economics Institute, ends with the following words: "Thus, the recent expansion of household net worth masks the fragility of the consumer expenditure boom. Net worth is useless for forecasting consumer spending. It rises right up to the start of every period of consumer retrenchment, even up to that notable episode that began in the fall of 1929."

GROWING EMU DOUBTS

In its annual report for 1996, the European Monetary Union says that most European Union countries had failed to control their budget deficits sufficiently to launch the euro in 1999. On average, the deficit-to-GDP ratio hit an estimated 4.4 percent, after 5.0 percent the year before. But that was a little higher than in 1991, when this ratio averaged 4.3 percent. In sum, there has been zero progress since the signing of the Maastricht treaty.

Only three of altogether 15 countries met the 3-percent target. The most drastic reduction was achieved by Sweden, where the deficit now stands 8 percentage points below its 12.3 percent peak in 1993. Beside Luxembourg, which has a small surplus, only Denmark and Ireland have managed to slash their deficit ratios

— to 1. percent and 1.6 percent, respectively. Among the worst performers are France and Germany. Both have substantially higher deficits than in 1991. Some German politicians like to excuse their miserable fiscal performance with the stupendous unification costs. But when these were at their highest, in the early 1990s, the deficit ratio was lower, implying that its increase since then is not attributable to unification costs.

Officially, the crucial decisions on European Monetary Union will be made in April next year. In practice, the probable outcome may well be anticipated on May 15. An official, small working group of experts will on that day, independent of the Finance Ministry, announce its estimates of tax receipts in Germany in 1997. Given recent extremely weak tax revenues, they are sure to reveal that Germany has no chance of meeting the Maastricht Treaty's 3 percent ceiling on public deficits. Open is only the size of the excess.

Now the good news for those who reject EMU. All 1997 fiscal data are coming in much worse than expected. A dearth in tax receipts and rising outlays for record unemployment are playing havoc with Germany's belated attempts to meet the Maastricht criteria on public finances. Embarrassingly for Mr. Kohl, his own budget, the German federal budget, is the chief culprit. In the first two months of the year, it ran a cash deficit of DM 31.7 billion, more than twice the DM 15.2 billion gap of January-February 1996. The biggest single reason for the fiscal malaise is a drastic shortfall in tax receipts.

GERMANY'S ERODING TAX BASE

The fact is that the former relationship between economic growth and tax revenue has dramatically deteriorated. Growth in nominal GDP no longer translates automatically into rising tax receipts. Over the last four years, the forecasts for 1997 tax revenues have been progressively slashed from originally DM 976 billion to DM 822 billion last November. Part of the revisions can be explained by changes in tax laws. However, there is a substantial unexplainable shortfall, except for the one explanation: an increase in tax dodging. Greetings from Arthur Laffer, whose curve is undoubtedly at work here, with a vengeance, on the downside.

With its steeply progressive income tax, Germany's tax receipts should rise faster than GDP, but the ratio of income tax receipts to GDP has actually declined since the early 1990s. Note: Germany's top marginal rate of income tax stands at present at 57 percent, and even 60 percent including a church tax. The top rate for corporate taxes is only slightly lower.

Just like rich individuals, major corporations have also found ways around Germany's high taxes, partly by exploiting tax loopholes and partly by shifting profits to subsidiaries in countries with lower taxes. Since 1991, corporate income has risen 25 percent, while entrepreneurial income tax payments have fallen almost 40 percent. Even the receipts from the value-added tax are declining in relation to income and GDP growth.

Based on recent tax receipt data, there is a very high probability that Germany will miss the 3 percent deficit limit by such a margin that it will have to ask for an EMU delay. True, the treaty explicitly allows some leeway on the fiscal targets. But any such softening is tied to one of two conditions: The deficit ratio "must have declined substantially and continuously and reached a level that comes close to 3 percent; or, alternatively, the excess over the reference value is only exceptional."

Neither Germany nor France would qualify for either of these two waivers because their deficit ratios have risen, not fallen, since the signing of the treaty. Just the same applies to the second fiscal target, the ratio of public sector debt to GDP. Here, the treaty sets a limit of 60 percent, "unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace". But since the signing of the treaty, this ratio in Germany's case has soared from 44 percent in 1990 to 61.5 percent in 1996, hitting at least 63 percent in 1997. In the case of France, the rise has been from 35 percent to 56 percent.

WHAT IF EMU FAILS?

We do not doubt that the leading German politicians, Mr. Kohl in the first place, will stop at nothing to implement EMU. But we trust that the German Constitutional Court will foil their attempts to violate the treaty. Any abolishment would certainly be dressed up as a mere delay. When the markets will begin to discount this as a serious possibility, we don't know; it is impossible to say. Yet, it seems appropriate to think about its potential effects on the financial markets and the currencies.

We see two main effects: The one is a strengthening of the DM and the currencies of the core DM bloc against the other European currencies, and the other one is some unwinding of the convergence game in the bond markets with rising yields for the peripheral countries. But the sharp decline of their longer-term interest rates largely also reflected a considerable improvement in fundamentals, such as considerably lower inflation and deficits.

Far more difficult to answer is the question, what will happen to the dollar/DM rate? The dollar may stay firm for a while longer, supported by the expectation of further Fed tightening. Still, we expect pronounced dollar weakness later in the year for reasons that lie entirely on the U.S. side.

CONCLUSIONS:

Don't be fooled by the strength in the Dow and the S&P 500. It stems from barely 100 blue-chip stocks. The great majority of stocks has been ailing for about a year. Many have suffered high double-digit losses.

Keep your eyes on high tech news and high tech stocks. During 1995-96, a disproportionate part of GDP growth came from high tech and financial services. What's more, the two sectors accounted for three quarters of all the profit gains among the stocks in the S&P 500. It's all hanging on high tech now. If the sector fails to recover strongly from its present weakness, be prepared for a crash of the market that will shatter the consumption boom.

The dollar's strength arises from firm U.S. economic growth and the expectation of upcoming further monetary tightening by the Fed. But later this year, this cyclical strength will be severely challenged by the weakening U.S. economy, a bearish stock market and a widening current-account deficit, heading for \$185 billion after \$165 billion last year. There is the potential for a steep fall of the currency, but foreign central banks will prevent the worst.

The International Monetary Fund has painted a particular rosy picture for the world economy, predicting some of the fastest growth rates seen in nearly a decade. However, it warns of two clouds: a destabilizing drop in world stock prices and record high unemployment in Europe.

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